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IN THE

Supreme Court of the United States

October Term, 1947

No. .....

LILY HO QUON and ALBERT T. QUON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Rzspondent.

Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

To the Honorable the Supreme Court of the United States:

Lily Ho Quon and Albert T. Quon, petitioners, respectfully pray the issuance of a writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit to review the affirmance by that court of decisions of the Tax Court of the United States ordering and deciding that there is a deficiency in income taxes of each of petitioners for the year 1941 in the amount of $9,835.08.

Proceedings in Courts Below.

On August 14, 1944, petitioners respectively filed petitions with the Tax Court of the United States, seeking a redetermination of their federal income tax liabilities for the taxable year ended December 31, 1941, pursuant to Section 272(a)(1) of the Internal Revenue Code. The proceedings were consolidated for hearing, and hearing was had on November 13th and 14th, 1946. On March 31, 1947, the Tax Court rendered its decisions denying relief to the petitioners and ordering and deciding that there was a deficiency in income taxes of each petitioner in the amount of $9,835.08. On January 2, 1948, the United States Circuit Court of Appeals for the Ninth Circuit affirmed the decisions of the Tax Court, without opinion. On February 11, 1948, it denied a petition for rehearing.

Facts Pertinent to This Petition.

1. Petitioners are husband and wife residing in Los Angeles, California. Unless otherwise indicated, the term "petitioner," in the singular, will be used herein to refer to Albert T. Quon. Petitioner was a resident alien [R. 32], and in 1941 and prior thereto, ineligible to citizenship (57 Stat. 601). Petitioner Lily Ho Quon was a citizen [R. 32]. Prior to May, 1941, petitioners owned, as community property [R. 38], a business operated as a sole proprietorship of petitioner under the name of Quon-Quon Company. The business involved importing Chinese decorative merchandise and wholesaling it [R. 32].

2. On May 1, 1941, petitioners, as co-trustors, created four separate trusts, one for each of their four minor

children. These children were all citizens. Concurrently with the creation of these trusts Quon-Quon Company was reorganized as a partnership, petitioners being constituted general partners and the trustees of the four trusts being constituted limited partners [R. 32].

THE TRUSTS.

3. The four trusts, in so far as here material, are essentially similar except for the identity of the beneficiaries and trustees [R. 32]. Petitioners, as co-trustors, irrevocably assigned to each trustee a 12½% interest in the said Quon-Quon Company [R. 32]. Under his respective trust instrument each trustee was required to invest such 12½% interest as limited partner in the limited partnership into which the Quon-Quon Company was then reorganized. It was also required that his corresponding share of the profits be credited to him and "distributed to him from time to time, pro rata with distribution to the general partners" [R. 33].

4. Each trustee was "vested with power," upon dissolution of said partnership, "to reinvest his distributive share of the proceeds therefrom, or any part thereof, in the capital assets or capital stock of any partnership, corporation or other company which may be organized for the purpose of acquiring the assets and continuing the operation of said business" [R. 33]. There is no provision requiring him so to reinvest his distributive share of the proceeds of dissolution, or any part thereof.

5. Each trustee was further authorized "to sell or exchange trust assets, purchase other assets, invest trust funds or borrow money and obligate or encumber the trust estate therefor, all only with the written consent of the

beneficiary after he attains 21 years of age or only with the written consent of the beneficiary's parents prior to such time" [R. 34].

6. Payments to the beneficiary of each trust out of accumulated income and principal of the trust estate were to begin when such beneficiary reached 21 and distribution of the entire income and principal was to be completed when he reached 35. If a beneficiary died before reaching 21 the trust estate was to go to *his* issue, or, if none, equally to the remaining trusts. If he died after reaching 21, the trust estate was to go to *his* heirs, devisees or legatees [R. 34]. There is no other provision for the beneficial use of either the income or the principal of the trust estate. The trustors reserved no interest of any kind.

7. Each trustee was entitled to compensation for ordinary and usual services of $50 a year. In the event of his absence from the state for an extended period of time a co-trustee could be appointed by a *competent court* to act during such period of absence. If a trustee resigned only a *competent court* could appoint a successor [R. 35].

THE PARTNERSHIP.

8. In the limited partnership into which the Quon-Quon Company was reorganized the petitioners became general partners, each with a 25% interest, and the four trustees of the four trusts became limited partners, each with a 12½% interest.

9. The partnership is for a term of 25 years. It can be dissolved by the death of a general or limited partner, or by the "withdrawal from the partnership of any general or limited partner" [R. 35]. Upon such dissolution of the

partnership and the liquidation of its assets the pro rata shares of the limited partners in the assets of the partnership are to be returned to them [R. 36].

EVENTS LEADING UP TO FORMATION.

10. In 1940 petitioner went to China to purchase merchandise for the business and was absent from this country approximately from April to August, inclusive, or about five months. During this period an employee named Fung "was in control of the business and operated it" [R. 36].

11. After petitioner returned from China in August, 1940, he became "concerned over the possibility that his business assets might be frozen by executive order since certain alien property in this country was becoming subject to such controls. Early in 1941 petitioner discussed the problem with various friends and advisors. The plan to create the trusts and the partnership, which was executed May 1, 1941, grew out of these discussions" [R. 36]. Since petitioner's children and wife were citizens, partial ownership of the business assets by them was considered a practical method of avoiding seizure to such extent [R. 37].

12. An additional factor found by the Tax Court to have been considered in setting up the trusts was petitioner's parental desire to make provision for the security of his children. Another was reduction of taxes [R. 36-37]. However, these additional factors were not part of the discussions out of which the plan grew. Those discussions related entirely to the possibility that petitioner's assets might be frozen. That was the originating and primary factor. This Court is requested to interpret the findings in respect to petitioner's purpose in the light of

the facts (1) that the Quon-Quon business "involved importing Chinese decorative merchandise and wholesaling it" [R. 32] and (2) that after 1940 China was substantially closed to American trade.

CONDUCT OF BUSINESS AFTER FORMATION.

13. After the creation of the partnership the manner of conducting the business was the same as prior to the partnership [R. 37]. There was a vital change, however, in the residence of the power over the business. Thereafter any one of the trustees could withdraw his interest and thereby cause a dissolution of the partnership and liquidation and distribution of its assets [R. 35, 36]. (See, also, paragraph 9 above.)

14. After the creation of the partnership, moreover, there were vital changes in the control and application of the earnings of the business. Petitioner received a salary from the partnership of $4,000 for the eight-month period from May 1, to December 31, 1941, or $500 per month. This was deducted in arriving at the net profits of the partnership [R. 37-38]. Petitioner could not draw against his share of the net profits without making pro rata distributions to the four trusts [R. 33]. Such distributions were made. At first such distributions to the trusts were made by purchase of securities for them and delivery thereof to the trustees. Later the trustees themselves directly purchased securities for the trusts from their distributive shares of net profit credited to them on the partnership books [R. 37].

Basis of Jurisdiction.

The jurisdiction of this Court is invoked under Section 1141(a) of the Internal Revenue Code.

The judgment of the Circuit Court of Appeals herein was filed on January 2, 1948. No opinion was filed. The decision and order on the petition for rehearing were rendered February 11, 1948.

Question Presented.

The sole question presented is whether the distributive shares of the four trusts in the earnings of the Quon-Quon Company are includible in the gross income of petitioners under the income tax provisions of the Internal Revenue Code.

Reasons Relied Upon for Allowance of the Writ.

1. The decision below is a misapplication of the decisions of this Court in *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293.

Under the Internal Revenue Code the net income of an individual who is a partner is expressly required to include his distributive share of the net income of the partnership. Therefore, the distributive share of each trust in the net income of the Quon-Quon Company was taxable to it and not to petitioners.

The exception of certain partnership interests created by intra-family gift from the scope of this statutory requirement under the doctrine of the *Tower* and *Lusthaus* cases has no application here. In those cases there was, in the guise of a partnership, a mere paper reallocation of income between husband and wife. Here the change was in economic realities. The trusts became the absolute

owners of the partnership shares which they acquired and the recipients of the economic benefits flowing therefrom.

2. The decision below is in conflict with the decision of this Court in *Commissioner v. Heininger*, 320 U. S. 467. The *Heininger* case shows that a purpose to protect a business from destruction is a normal business purpose. Not only is that purpose consistent with, but in fact confirms, the bona fides of the partnership here.

3. The decision below is in conflict with the decision of this Court in *Oyama v. California*, 332 U. S. 633. The *Oyama* case shows that in the circumstances here involving a transfer by a father ineligible to citizenship to his citizen children, no presumption of want of *bona fides* can be drawn.

4. The decision below is in conflict with a decision of the United States Circuit Court of Appeals for the Second Circuit in *Standard Oil Co. v. Clark*, 163 F. (2d) 917, certiorari denied April 19, 1948, Dockets 576, 641, and a decision of the Circuit Court of Appeals for the Third Circuit in *Miller v. Herzfeld*, 4 F. (2d) 355. Both of those cases sustain the principle that transfers of property made in contemplation of war and for the specific purpose of avoiding its normal consequences are valid.

5. The decision below is in conflict with the decision of the United States Circuit Court of Appeals for the Fifth Circuit in *Thomas v. Feldman*, 158 F. (2d) 488. The *Feldman* case holds that a partnership is not invalid for federal tax purposes with respect to any partner merely

because such partner obtained his interest by gift from another partner and rendered no service to the partnership. That case came up from a District Court instead of the Tax Court, but the question is not one of finding of fact, but one purely of law as to the treatment under given facts for federal tax purposes. On that question, the decision below is in direct conflict with the *Feldman* case.

Prayer.

For the foregoing reasons, which are developed in more detail in the accompanying brief, your petitioners pray that a writ of certiorari issue out of this Court to the United States Circuit Court of Appeals for the Ninth Circuit commanding said Court to certify and send to this Court on a date to be designated, a full and complete transcript of the record and of all proceedings had by the Circuit Court of Appeals in this case, to the end that this case may be reviewed and determined by this Court, and that the judgments and decisions of the Circuit Court of Appeals be reversed.

Respectfully submitted,

GEORGE T. ALTMAN,
Attorney for Petitioners.

Certificate of Counsel.

I hereby certify that in my judgment the foregoing petition for a writ of certiorari is well founded and that it is not interposed for delay.

GEORGE T. ALTMAN,
Attorney for Petitioners.

Dated: Los Angeles, California, May 6, 1948.

IN THE

Supreme Court of the United States

October Term, 1947.

No. .....

LILY HO QUON and ALBERT T. QUON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

I.

The Decision Below Is a Misapplication of the Decisions of This Court in Commissioner v. Tower, 327 U. S. 280, and Lusthaus v. Commissioner, 327 U. S. 293.

A. Misapplication of a decision of this Court is ground for a writ of certiorari. (*Johnson v. U. S.*, 333 U. S. 46.)

B. As shown in the appendix, page 26, Section 182 of the Internal Revenue Code expressly provides that the net income of a partner shall include, whether or not distribution is made to him, his distributive share of the net income of the partnership. In the *Tower* and *Lusthaus*

cases this Court excepted from the application of that section partnership arrangements which were not economic realities. Petitioners do not question that exception. On the contrary, they submit that the principle that the income tax must be based on economic realities is basic to the entire concept of the income tax. The *Tower* and *Lusthaus* cases are but part of a chain of cases applying and developing that principle. (*Commissioner of Internal Revenue v. Sunnen,* decided by this Court April 5, 1948, Docket No. 227, 16 U. S. Law Week. 4310.) Thus interpreting the *Tower* and *Lusthaus* cases they have no application here. A detailed comparison of those cases with the case here will make this fact clear.

In the *Tower* case the taxpayer, sole owner of a corporation except for a 1% interest in his wife and a 10% interest in one Amadon, transferred another 38% to his wife, retaining the balance of 51%, and then converted the corporation into a partnership. The question was whether the income attributable to the wife's share under the partnership agreement was taxable to her husband. The reason for forming the partnership was that it "would result in tax savings and eliminate the necessity of filing the various corporate returns." The partnership was to last for twenty years unless sooner terminated by a decision of a majority in interest of the partnership capital. As stated above, the husband held 51%. No salary was paid to the husband before determining the amount of the profits to be distributed. In fact, Amadon's share of the profits was adjusted so as indirectly to preserve Amadon's previous salary and at the same time throw the amount previously paid the taxpayer as salary into the portion of the profits to be shared between the taxpayer and his wife. The wife's share of the earnings, this

Court held, was "income produced by the husband's efforts." This Court also stated:

> "The wife drew on income which the partnership books attributed to her only for the purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed. Consequently the result of the partnership was a mere paper reallocation of income among the family members. The actualities of their relation to the income did not change."

In the *Lusthaus* case a husband-wife partnership was likewise involved. There also the question was whether the income attributable to the wife's share under the partnership agreement was taxable to her husband. There the purpose was also entirely to reduce income taxes. There likewise the wife could not withdraw her interest without her husband's consent. There also the husband drew no salary. There, too, the wife's withdrawals of earnings were not used or held for her separate benefit. They were used largely to pay back some of the notes given by her to her husband in part payment of the purchase price of her alleged contribution to the partnership capital.

In these cases this Court, by way of illustration, pointed out factors which the Tax Court *could* properly take into consideration in determining that a partnership was real for tax purposes. But in neither one did it lay down conditions which *must* appear in order that a partnership be considered real for tax purposes. This Court laid down no categorical imperatives. The issue was one between reality and fiction. Reality cannot be cast into any fixed and narrow mold. This Court made no attempt to do so.

Comparing now the *Tower* and *Lusthaus* cases with the case at bar, those cases are seen to be distinguishable in every material factor. The distinctions are as follows:

1. In the *Tower* and *Lusthaus* cases the income involved was the distributive share of the wife. Here it is the distributive shares of trusts for minor children. What husband and wife may do with their money as between themselves is entirely a matter between themselves. What parents may do with the property of their children is a wholly different matter.

In California a parent as such has no control by operation of law over the property of the child. Civil Code of California, Section 202. If he is made guardian he is liable as trustee and is subject to regulation and control by the court. (*Oyama v. California,* 332 U. S. 633, Footnote 24, citing Probate Code of California, Section 1400.) If under a trust instrument he holds a power for the benefit of the trust he, as any one else, is with respect to the exercise of such power liable as trustee; and the express trustee may reject his attempted exercise of such power in violation of the fiduciary relation. (American Law Institute, Restatement of Trusts, Section 185; *Cushman, Jr. v. Commissioner* (C. C. A. 2), 153 F. (2d) 510.)

Here, then, the income involved was in wholly different position from that involved in the *Tower* and *Lusthaus* cases. Here it was not that of a wife, which might be subject to the husband's command. Here it was that of minor children, protected by trustees, a separate trustee for each child, and protected further by the special solicitude of the law. The exclusion of this income from the parent's dominion could not be greater if it were owned by total strangers.

2. In the *Tower* and *Lusthaus* cases the sole purpose was tax saving. Here the originating and primary purposes was protection of the business from destruction by freezing orders. The Tax Court found this as a fact. It made no finding that the transfers of interest were a sham, or that they were not *bona fide* and valid. On the contrary, it found as a fact that the petitioners, as co-trustors, "created four separate trusts," and "irrevocably assigned" the interests involved to the respective trustees. It found as a fact that concurrently "with the creation of these trusts Quon-Quon Company was reorganized as a partnership, petitioners being constituted general partners and the trustees of the four trusts being constituted limited partners." It found as a fact that the partnership could be dissolved by the "withdrawal from the partnership of any general or limited partner." It found as a fact that the distributive share of each trustee in the net income of the partnership was required to be distributed to him "pro rata with distribution to the general partners." It found as a fact that such distributions were actually made and that the amounts of such distributions were invested by the trustees in securities. Every finding bears out and emphasizes the utter honesty and completeness of the transfer of partnership interests to the trusts. Is this any the less significant because the purpose was to protect the business involved from destruction? That purpose, on the contrary, explains the thoroughness and completeness with which the change was carried out.

3. In the *Tower* and *Lusthaus* cases the partnership could not be terminated without the consent of the donor partner. Here any of the trustees could by withdrawing his interest terminate the partnership.

That a power of withdrawal is proof of real ownership is shown in *Ralph W. Conant v. Com.*, 7 T. C. 577. In that case, the taxpayer created four trusts of each of which his wife was primary beneficiary. She was given the absolute power to cancel the trusts at any time and take over their corpus and undistributed income. The Court held there that that power of withdrawal prevented taxability of the income to the trustor.

4. In the *Tower* and *Lusthaus* cases the donor partner received no salary for his services to the partnership before determination of earnings divisible among the partners. Here the donor partner, petitioner, was paid for his services and such payment was deducted in arriving at the net profit divisible among the partners. The services of petitioner are therefore excluded as a factor in the case here.

5. In the *Tower* and *Lusthaus* cases the distributions of earnings to the donee partner, the wife, were not used or held for her separate benefit. In the *Tower* case they were used for the purposes of buying and paying for the type of things she had bought for herself, home and family before the partnership was formed. In the *Lusthaus* case they were used to pay her husband on the notes given by her as part payment of the purchase price of her alleged contribution to the partnership capital. Here, however, the distributions to the trusts were invested in securities by the trustees and accumulated for the respective beneficiaries.

The above contrast of the *Tower* and *Lusthaus* cases with the case here shows the basic character of the distinction here. Measured in terms of economic realities the income involved in the *Tower* and *Lusthaus* cases was in fact the income of the husband in each case. Here measured in the same terms the income involved is in fact the income of the trusts, and not of petitioners.

II.

The Decision Below Is in Conflict With the Decision of This Court in Commissioner v. Heininger, 320 U. S. 467.

The facts found here by the Tax Court are uncontroverted [R. 44]. The Tax Court in its opinion here, however, concluded that the purpose to avoid the freezing of business assets was not the kind of a business purpose "which is indicative of the essential intent to really and truly join together for the purpose of carrying on business as partners." The Tax Court made no finding of fact that such an intent was absent. It made a finding of the purpose of the partnership, to avoid the freezing of business assets, and from that purpose drew a conclusion *as a matter of law* that there was no intent to really and truly carry on business as a partnership.

In the *Heininger* case the question was whether legal expense incurred in protecting a business from destruction as a result of charges of illegal acts was an "ordinary and necessary" expense of the business. Although the Tax Court there did not say so expressly, it treated that question, this Court observed, *as a question of law.* It decided against the taxpayer. Appeal was taken to the Circuit Courts of Appeals for the Seventh Circuit, which reversed

the Tax Court's holding. This Court sustained the Circuit Court's decision.

The Circuit Court in that case (133 F. (2d) 567) stated:

> "We think that where an expense is incurred which saves the life of a business, even for a time, it is, in the light of the above interpretation, not only a business expense, but a necessary business expense. Without the expenditure, there would have been no income in this case because there would have been no business. The business depended directly upon the expense incurred in the litigation. We therefore hold that the expense was both ordinary and necessary."

And this Court stated:

> "For respondent to employ a lawyer to defend his business from threatened destruction was 'normal'; it was the response ordinarily to be expected."

It would indeed be odd if anyone faced with destruction of his business failed to make an attempt to save it. Does that make the act done for that purpose any the less complete and *bona fide?* It would not even be strange under the circumstances here if petitioner had not only given half of his business to his children for the purpose of saving it, but had given them the entire business. What father conscious of the welfare of his children would fail to turn his business over to them where otherwise it would go down to destruction? Is a transfer for that reason any the less complete and *bona fide?* The facts found here lend no support whatever to such a conclusion.

III.

The Decision Below Is in Conflict With the Decision of This Court in Oyama v. California, 332 U. S. 633.

The *Oyama* case involved a gift by a resident alien ineligible to citizenship, to his minor son, a citizen. The gift was made by a purchase of land in the son's name, the father then having himself appointed guardian. Under the law of California the father could not own real estate, but the son could. The State charged that the real purchaser and owner was the father, not the son, and that the purchase in the son's name was a mere technical shifting of title to avoid the California Alien Land Law. (332 U. S. 633, 639.) But this Court reversed, saying that in the circumstances "the burden of proving that there was in fact no completed *bona fide* gift falls to him who would attack its validity." (*Supra*, p. 641.) With respect to the guardianship the Court observed that as guardian the father was subject to the law of trusts, citing Section 1400 of the California Probate Code. (*Supra*, pp. 643-4, footnote 24.)

Here the facts are in substance the same. Petitioner Albert T. Quon was a resident of the United States but of Chinese ancestry, and therefore in 1941, the year here involved, ineligible to citizenship. (*Supra*, p. 635, footnote 3.) Solely because of his ancestry, and for no other reason, the business upon which his wife and four minor children, all citizens of this country, depended for their security, was threatened with destruction by the program established under Executive Order of freezing the assets of enemy aliens and aliens whose countries had been or were being subjected to enemy control. As a result of these impelling circumstances Albert T. Quon made the

transfers involved here to his citizen wife and children. The *Oyama* case shows that from such circumstances no presumption of want of *bona fides* in the transfers can be drawn. That case shows therefore as complete *non sequiturs* the Tax Court's reasoning in its opinion here that the "desire to avoid the freezing of assets in fact indicates that the arrangement was intended merely as a *technical* shifting of title from alien to citizen" and that the "*purported* limited partners in a sense constituted *mere depositories* of title for purposes other than those connoting a true partnership." (Italics supplied.)

If this Court believes that any of the facts cited under this point are not clearly shown in the Tax Court's findings, petitioners request a remand for that purpose. The *Oyama* decision of this Court was, of course, not available when the case here was heard by the Tax Court.

IV.

The Decision Below Is in Conflict With a Decision of the United States Circuit Court of Appeals for the Second Circuit in Standard Oil Co. v. Clark, 163 F. (2d) 917, Certiorari Denied April 19, 1948, Dockets 576, 641, and a Decision of the Circuit Court of Appeals for the Third Circuit in Miller v. Herzfeld, 4 F. (2d) 355.

A. In the *Standard Oil Co.* case, *supra,* plaintiffs were American corporations. The defendant was the Alien Property Custodian from whom the plaintiffs were seeking to recover certain patents and shares of stock as having been sold to them by a German national. The stock involved included 200 shares of S.I.G. stock sold to the plaintiffs in September, 1939. We shall refer to that transaction as the "S.I.G." transaction. With reference

to that transaction the District Court (*Standard Oil Co. v. Markham,* 64 F. Supp. 656, 664) stated:

> *"It is well settled that genuine transfers of property, made in contemplation of war and for the specific purpose of avoiding its normal consequences, are valid.* (Italics supplied.) Magg v. Miller, 54 App. D. C. 226, 296 F. 973; Miller v. Herzfeld, 3 Cir., 4 F. 2d 355; Waldes v. Schall, D. C. S. D. N. Y., 11 F. 2d 444, 452, affirmed, 2 Cir., 11 F. 2d 453; Metz v. Garvin, D. C. S. D. N. Y., 3 F. 2d 182. All that is necessary is that before 'the whole nation are embarked on one common bottom' (see The Rapid, 8 Cranch 155, 161, 3 L. Ed. 520) the transfer be in every respect finally consummated without thought of subsequent modification."

In affirming the decision of the District Court on the issue involving the S.I.G. transaction the Circuit Court of Appeals for the Second Circuit (163 F. (2d) 917, 927) stated:

> "Since the court found the transaction to be one designed in good faith to pass title to Standard, the stock belonged to Standard when vested and Standard is entitled to recover it."

The plaintiffs in the case filed a petition for writ of certiorari, October term, 1947, Docket No. 576. The issue involving the S.I.G. transaction having been decided in their favor, it was of course not raised in their petition for certiorari. However, the Attorney General filed a condi-

tional cross-petition, Docket No. 641. In that cross-petition he attacked the S.I.G. transaction. He did not, however, question the principle quoted above from the District Court's decision. He questioned only the finding of fact as to "whether there was an unwritten agreement to return the shares at the end of the war." The principle supporting the decisions of the District and Circuit Courts —that a *bona fide* transfer is not invalid because made in contemplation of war and for the specific purpose of avoiding its normal consequences—was wholly unchallenged. The petition and cross-petition were denied April 19, 1948.

B. While the *Standard Oil* case, *supra,* involved the validity of a sale, the case of *Miller v. Herzfeld* (C. C. A. 3), 4 F. (2d) 355 (1925), involved the validity of a gift. This latter case, it may be observed, was relied on as authority in the *Standard Oil* case. The events occurred in 1917. A German subject residing in Germany had property in the United States. Three days after severance of diplomatic relations between the United States and Germany but before the outbreak of war, this German national made a gift of the property to his brother in the United States. The gift as made was complete under local property law. It was held on that basis that the Alien Property Custodian was not entitled to the property.

V.

The Decision Below Is in Conflict With the Decision of the United States Circuit Court of Appeals for the Fifth Circuit in Thomas v. Feldman, 158 F. (2d) 488.

In the *Feldman* case the taxpayers, as here, were husband and wife holding their property as community property. They reorganized two businesses as limited partnerships, with taxpayer J. Feldman as general partner and a trust for the benefit of their children as limited partner. There, as here, the limited partnership interests were created by gift from the taxpayers. On the finding that the gifts creating the trusts were *"bona fide,* valid and irrevocable," that the donors ceased to be "the beneficial owners of the trust property or the recipients of the income therefrom," and that none of the income or corpus of the trust was used for their "personal benefit or economic gain," the partnership income allocated to the trust was held not taxable to the donors.

The trier of fact here, the Tax Court, decided against the taxpayers as a matter of law. But it did not find any lack of *bona fides, as a fact.* Its findings of fact were identical with those in the *Feldman* case, to the extent of the findings in that case. The case here, moreover, contains several additional elements which make the taxpayers' position here even stronger. There is here a finding of business purpose; of power of the trustee of any of the trusts to terminate the partnership; of compensation paid petitioner as general partner for his services.

Conclusion.

The distributive shares of the four trusts in the earnings of the Quon-Quon Company were, in terms of economic realties, the income of those trusts and should therefore not be included in the gross income of petitioners under the income tax provisions of the Internal Revenue Code.

Respectfully submitted,

GEORGE T. ALTMAN,
Attorney for Petitioners.

APPENDIX.

Provisions of Internal Revenue Code Involved Herein.

"Sec. 11. NORMAL TAX ON INDIVIDUALS.

"There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 4 per centum of the amount of the net income in excess of the credits against net income provided in section 25."

"Sec. 12. SURTAX ON INDIVIDUALS.

"(a) DEFINITION OF 'SURTAX NET INCOME.'—As used in this section the term 'surtax net income' means the amount of the net income in excess of the credits against net income provided in section 25(b).

"(b) RATES OF SURTAX.—There shall be levied, collected, and paid for each taxable year upon the surtax net income of every individual the surtax shown in the following table: . . ."

. . . . . .

"Sec. 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; . . ."

. . . . . .

"Sec. 181. PARTNERSHIP NOT TAXABLE.

"Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

"Sec. 182. TAX OF PARTNERS.

"In computing the net income of each partner, he shall include, whether or not distribution is made to him—"

. . . . . .

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership. . . ."

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IN THE

Supreme Court of the United States

October Term, 1947

No. 791

LILY HO QUON and ALBERT T. QUON,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT.

Brief of Petitioners in Reply to Respondent's Brief in Opposition

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Respondent.

Brief of Petitioners in Reply to Respondent's Brief in Opposition.

1. Respondent's "Statement" Inaccurately Reflects the Tax Court's Findings of Fact Here.

A. The bona fides of the partnership here is an important factor in petitioners' case. Nowhere in its findings of fact—at not a single point—did the Tax Court utter any suggestion that the partnership was not bona fide. Yet, in several sentences otherwise drawn verbatim from those findings respondent has inserted his own qualifying adjective in reference to the partnership. Thus, on page 6 of his brief, 3rd line from the bottom, he has inserted the word "purported"; on page 7, line 10, the word

"alleged"; on page 8, 9th line from the bottom, the word "so-called"; and on page 9, line 16, again the word "so-called."

That the opinion of the Tax Court in this respect involves wholly a conclusion of law, and an erroneous conclusion of law, is shown in petitioners' brief in support of their petition, pages 17-22.

B. Another important factor in petitioners' case is that the income involved here is not attributable to petitioners, and is attributable to the limited partners because of their ownership of capital shares. Affecting that issue are these words of respondent, on page 8, line 6:

> "After his [taxpayer's] return from a business trip to China in August, 1940. . . ."

The Tax Court's findings of fact show, however, that taxpayer's trip lasted from April to August and that during that period "an employee named Fung was in *control* of the business and *operated* it." [R. 36—italics supplied.] This fact is important. The Tax Court in its opinion stated that the business was "operated" and "controlled" by the taxpayer prior to the formation of the partnership [R. 38]; also that for all practical purposes the business continued to be "operated" and "controlled" after the conversion to the partnership form in the same manner as before [R. 38-39]. The conclusion must be that the Tax Court was using the terms "operated" and "controlled" in a very general sense. It made no attempt to convey the impression, let alone to find directly, that the

business was dependent upon the taxpayer, nor that, as respondent charges in his argument (p. 14), any part of the income actually involved here was attributable to the "services, control and management" of the taxpayer. The Tax Court could only have meant that the taxpayer was in general charge of the business. So was the taxpayer in the *Feldman* case, cited by petitioners in their brief in support of the petition (p. 23). Here, moreover, the taxpayer was paid for his services, and nowhere did the Tax Court find, nor does respondent charge, that the compensation was inadequate.

2. Respondent's "Argument" Fails to Meet the Real Issues Involved Here.

A. Respondent in his argument (p. 13), states that "it is clear from the Tax Court's opinion [R. 38-40] that it was unable to find that a bona fide partnership had been created for federal income tax purposes." In attempting to distinguish the *Feldman* case, however, respondent (p. 14) pointed out that the trial court there had found as a fact that "a bona fide partnership had been created . . .", not that "a bona fide partnership had been created for federal income tax purposes. . . ." The resulting distinction is defective on its face. It begs the question of law as to the meaning of bona fides *for federal income tax purposes.*

In the *Feldman* case the trial court had found that the gifts were "bona fide, valid and irrevocable", that the donors ceased to be "the beneficial owners of the trust

property or the recipients of the income therefrom", and that none of the income or corpus of the trust was used for their "personal benefit or economic gain." On the basis of those findings, the Circuit Court of Appeals for the Fifth Circuit held that the partnership income allocated to the trust was not taxable to the donors. The Court there treated bona fides as a separate factor, as simply bona fides, and on the basis of all of these factors combined, reached its conclusion. All of these factors are as fully present in the case here as they were in the *Feldman* case. As petitioners pointed out, moreover, in their brief in support of the petition (p. 23), the case here contains several additional elements which make the petitioners' case even stronger. There is a clear conflict between the decision of the court below in this case and the decision of the court in the *Feldman* case.

B. Respondent in his argument (p. 12) also misstates the opinion of this Court in the *Tower* case. This Court did not say there that "unless the donee or assignee 'invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things', the Tax Court is justified in concluding that the donee or assignee is not a real partner for tax purposes." This Court only said that the Tax Court could "properly take these circumstances into consideration" in determining whether the partnership is real within the meaning of the federal revenue laws.

Here, of course, the limited partners rendered no services. That is just what limited partners as such are not supposed to do. As to contribution of capital, the shares which the limited partners owned were absolutely theirs; for as pointed out in petitioners' brief in support of the petition (pp. 15-16), any limited partner could terminate the partnership and withdraw his capital share. Respondent states in his argument, however (p. 14), that the capital "emanated" from the taxpayer or the marital community. In that he is attempting to engraft upon the federal income tax a wholly new theory—one that has no basis in principle and finds no support anywhere in the entire history of the federal income tax.

Conclusion.

Petitioners submit again that the decision below is erroneous, that it is in conflict with other decisions, both of this Court and other Circuit Courts of Appeals, and that the petition for a writ of certiorari should be granted.

Respectfully submitted,

GEORGE T. ALTMAN,

Attorney for Petitioners.

June 10, 1948.

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In the Supreme Court of the United States

OCTOBER TERM, 1947

No. 791

LILY HO QUON AND ALBERT T. QUON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 31–40) are not reported. The opinion of the Circuit Court of Appeals (R. 54) is reported at 165 F. 2d 215.

JURISDICTION

The judgment of the Circuit Court of Appeals (R. 55) was entered on January 2, 1948. A petition for rehearing was denied on February 11, 1948. (R. 56). The petition for a writ of certiorari was filed on May 8, 1948. The jurisdiction of this Court is invoked under Section

240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, on the facts found by the Tax Court, petitioners, husband and wife, are taxable under Section 22 (a) of the Internal Revenue Code upon part of the income of certain trusts set up by them, for the benefit of their four minor children, out of one-half of the assets of an alleged family partnership, the business of which previously had been conducted by the husband as a sole proprietorship.

STATUTES INVOLVED

Internal Revenue Code:

> SEC. 22. GROSS INCOME.
>
> (a) *Deneral Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 1940 ed., Sec. 22.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 1940 ed., Sec. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b). (26 U. S. C. 1940 ed., Sec. 182.)

STATEMENT

This proceeding involves deficiencies in federal income taxes asserted against each of the petitioners in the sum of $9,835.08 for the taxable year 1941. (R. 31, 40, 41.) The facts found by the Tax Court are as follows (R. 32–38):

The petitioners are husband and wife residing in Los Angeles, California.[1] The husband, Albert T. Quon, is a resident alien. His wife, Lily Ho Quon, is a citizen. Prior to May, 1941, the husband, as sole proprietor, operated a business under the name of Quon-Quon Company. The business involved importing Chinese decorative merchandise and wholesaling it. (R. 32.)

[1] The husband, Albert T. Quon, is sometimes referred to herein as the taxpayer, while both are sometimes referred to jointly as the taxpayers.

On May 1, 1941, the taxpayers, as co-settlors, created four separate trusts, one for each of their four children, then ranging in age from ten to four years, respectively. The children are all citizens. Concurrently with the creation of these trusts Quon-Quon Company was reorganized as a partnership, the taxpayers being constituted general partners and the trustees of the four trusts being constituted limited partners. (R. 32.)

All of the four trusts, to the extent material here, are essentially similar except for the identity of the beneficiaries and the trustees.[2] The trust indentures (R. 15–22) recite that Albert T. Quon "owns and operates" Quon-Quon Company, which business was community or joint property of the taxpayers, and that they desired to make provision and settlement for the designated child by irrevocable transfer, in trust, of an interest in such business (R. 15). The taxpayers, as co-trustors, thereupon assigned to the named trustee an undivided 12½ percent interest in the business of Quon-Quon Company, subject to the terms of a partnership agreement executed concurrently therewith under which the taxpayers were to be general partners and the several trustees were to

[2] The Tax Court referred to the pertinent provisions of the trust for their son, Ronald, as typical of the material provisions of all of the trusts (R. 32–35), but the trust for the benefit of a daughter, Lillian Mae, is the only one included in the printed record (R. 15–22).

be limited partners. The trust instruments provided (R. 16) that concurrently with the execution thereof the business should be reorganized as a limited partnership and that the trustee should become a limited partner therein. As such limited partner and as trustee under the trust indenture he was to have a 12½ percent interest in the business and was to receive 12½ percent of the net profits, to be credited to and distributed to him from time to time, pro rata, with distributions to the general partners. Upon termination, dissolution, or reorganization of the business the trustee had power to reinvest his distributive share of the proceeds therefrom, or any part thereof, in the capital assets or capital stock of any partnership, corporation or other company which may be organized for the purpose of acquiring the assets and continuing the business of the partnership. (R. 17.)

Under the trust indentures the trustee was further authorized to sell or exchange trust assets, purchase other assets, invest trust funds or borrow money and obligate or encumber the trust estate therefor, but all only with the written consent of the beneficiary after she attained 21 years of age, or only with the written consent of the parents or legal guardian of the beneficiary prior to that time. (R. 17.)

The trust instruments further provided that when the beneficiary reached the age of 21 years, the trustee should thereafter pay him or her from

the income or principal, or both, of the trust estate such amount as in the trustee's discretion would be necessary to maintain the standard of living to which he or she had been theretofore accustomed, if the parents or surviving parent were not ready, willing, and able to provide such funds for the beneficiary. (R. 18.)

The trust instruments further provided that when the beneficiary reached the ages of 21, 25 and 30 years, the trustee should pay him or her, respectively, one-fourth, one-third, and one-half of the then accumulated income and principal of the trust estate other than the partnership interest in Quon-Quon Company. When the beneficiary reached the age of 35 years the trustee was to pay him or her the entire remainder of the estate and the trust was to terminate. If the beneficiary should die before attaining the age of 21 years, the trust estate was to go to his or her issue or, if none, equally to the remaining trusts. If the beneficiary should die after reaching the age of 21 years, the trust estate was to go to his or her heirs, devisees, or legatees. (R. 18–19.) Other provisions of the trusts (R. 20–21) are not material here.

Concurrently with the creation of the above trusts, Quon-Quon Company was reorganized into a purported limited partnership. The taxpayers were general partners, each having a 25 per cent interest, and the four trustees of the four trusts

were limited partners, each having a 12½ per cent interest in the partnership. Each general partner contributed to the partnership an undivided 25 per cent interest in the business of Quon-Quon Company. Each limited partner contributed to the partnership an undivided 12½ per cent interest in the partnership business, each such 12½ per cent interest being valued at $11,268.06. (R. 35.)

The alleged partnership is for a term of 25 years. It can be dissolved by the death of a general or limited partner, the transfer or attempted transfer of the interest of any general or limited partner, the retirement or withdrawal from the partnership of any general or limited partner. The substitution of a successor trustee as a limited partner will not operate to dissolve the partnership. (R. 35.)

Each limited partner and the general partners agreed to contribute to the partnership capital a pro rata amount, based on his or her respective interest in the partnership assets and profits, but only out of his or her share of the net profits from the business, sufficient in the aggregate to pay all obligations of the business theretofore or thereafter incurred, and to provide adequate working capital. No definite time was agreed upon for the return of the contributions of the limited partners. Their pro rata shares of the capital assets of the partnership were to be returned to them concur-

rently and pro rata with distributions to the general partners, upon termination of the partnership and liquidation of its assets. (R. 26–27, 35–36.)

As early as 1939 the taxpayer discussed the advisability of creating trusts for his children but nothing was then done. After his return from a business trip to China in August, 1940, he became concerned over the possibility that his business assets might be frozen by executive order since certain alien property in this country was becoming subject to such controls. The plan to create the trusts and the partnership was prompted by various considerations. One consideration was the taxpayer's parental desire to make provision for the security of his children. Another consideration was the fear of having the assets of his business frozen by the Government, and since his children and wife were citizens partial ownership of the business assets by them was considered a practical method of avoiding seizure to that extent. Another consideration was the reduction of taxes. (R. 36–37.)

After creation of the so-called partnership, the business of Quon-Quon Company continued to be conducted in all material respects in the same manner as it had been conducted prior to the partnership. The limited partners played no part in the conduct of the business. Capital and drawing accounts were set up on the partnership books for each limited partner. To each limited partner's capital account was credited 12½ per cent of the

partnership's net profit. Checks were drawn from time to time by the taxpayer on the partnership's commercial account, payable to various banks and brokers, which checks were ratably charged against the limited partners' drawing accounts. These checks were drawn to purchase securities which were delivered by the taxpayer to the trustees. Later the trustees themselves directly purchased securities for the trusts from the amounts credited to them on the partnership books. These purchases were approved by the taxpayers as parents of the beneficiaries. (R. 37.)

On the taxpayers' income tax returns for 1941 the income of Quon-Quon Company from January 1, 1941, to April 30, 1941, inclusive—the period prior to formation of the so-called partnership—was shown in the amount of $40,580.19, which amount included the husband's salary of $4,000 from the partnership for the eight month period, May to December, inclusive. This amount was also reported on a community property basis. Each trust reported as its share of the partnership income for 1941 the amount of $9,094.94, or an aggregate amount of $36,379.76, for the four trusts. In determining the deficiencies here involved the Commissioner added one-half of this latter amount, or $18,189.88, to the income of each of the taxpayers. (R. 37–38.) In determining the deficiencies here involved the Commissioner held that the income reported by the four trusts was taxable to the taxpayers under Sec-

tions 22 (a), 166 and 167 of the Internal Revenue Code. (R. 13–14, 38.) In its opinion (R. 38) the Tax Court held that on the foregoing facts this case is controlled by the decisions of this Court in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293. The Circuit Court of Appeals affirmed without opinion. (R. 54.)

ARGUMENT

This is another case involving the taxation, for federal income tax purposes, of the income of a so-called family partnership. The case was correctly decided by the Tax Court and the court below, and no question is presented here which would justify the granting of a writ of certiorari. The courts below properly applied the criteria established in *Commissioner* v. *Tower,* 327 U. S. 280, and *Lusthaus* v. *Commissioner,* 327 U. S. 293, and the decision is in accord with numerous other cases in the Circuit Courts of Appeals and the Tax Court.

We have here a situation wherein a sole proprietorship originated, operated and controlled by petitioners is converted into a partnership which purports, by trust mediums, to include as limited partners petitioners' minor children. No capital not originating with petitioners has been contributed by the trusts. No services are contributed to the partnership by the trustees. The business for all practical purposes continues to be

operated and controlled the same after conversion to the partnership as it was before.

As this Court pointed out in the *Tower* case, *supra* (p. 286), a partnership is generally said to be created when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business, and when there is a community of interest in the profits or losses. But no such arrangement was intended or accomplished here. The Tax Court found the considerations prompting the taxpayer to make the arrangements here involved were a parental desire to provide for the security of his children, an attempt to avoid freezing his business assets by the Government, and reduction of taxes. (R. 36–37.) No new capital was contributed and no new services were performed by the trustees or their beneficiaries.

In the *Tower* and *Lusthaus* cases, *supra,* this Court indicated that the decisive question in such family arrangements is not who owns a share of the capital, but who produced the income. In those cases this Court held that family partnerships erected upon gifts or unreal assignments of business capital, though valid and enforceable under state law, are without federal income tax significance if the arrangement produces no substantial change in the creation or production of the business income, but merely represents a reallocation of such income within the family group.

Unless the donee or assignee "invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things" (*Commissioner* v. *Tower, supra,* p. 290), the Tax Court is justified in concluding that the donee or assignee is not a real partner for tax purposes. Furthermore, this Court clearly indicated in the *Tower* case, *supra* (p. 287), that the Tax Court's determination as to the reality of a so-called family partnership for federal income tax purposes is final and not reviewable if supported by substantial evidence.

The taxpayer assigns as one ground for the granting of the writ here the alleged misapplication of this Court's decisions in the *Tower* and *Lusthaus* cases, *supra.* (Pet. 7.) But the purported distinction between the instant case and the cases just cited (Br. 11–17) is without material substance. Purported assignments of ownership of the business capital to members of the family other than the other spouse do not give rise to a real partnership for purposes of the federal income tax. *Scherf* v. *Commissioner,* 161 F. 2d 495 (C. C. A. 5th), certiorari denied, 332 U. S. 810; *Wilson* v. *Commissioner,* 161 F. 2d 556 (C. C. A. 4th), certiorari denied, 332 U. S. 769; *Fletcher* v. *Commissioner,* 164 F. 2d 182 (C. C. A. 2d), certiorari denied March 15, 1948,

No. 566, present Term; *Appel* v. *Smith,* 161 F. 2d 121 (C. C. A. 7th).

The above principles are no less applicable where, as here, the gift is to trustees for the benefit of the taxpayer's children. Passage of titular ownership of a portion of the business capital to a fiduciary instead of directly to the donee affects the legal form but not the economic substance of the arrangement. *Belcher* v. *Commissioner,* 162 F. 2d 974 (C. C. A. 5th), certiorari denied, 332 U. S. 824; *Eisenberg* v. *Commissioner,* 161 F. 2d 506 (C. C. A. 3d), certiorari denied, 332 U. S. 767; *Hash* v. *Commissioner,* 152 F. 2d 722 (C. C. A. 4th), certiorari denied, 328 U. S. 838, rehearing denied, 328 U. S. 879; *Dawson* v. *Commissioner,* 163 F. 2d 664 (C. C. A. 6th); *Benson* v. *Commissioner,* 161 F. 2d 821 (C. C. A. 5th); *Losh* v. *Commissioner,* 145 F. 2d 456 (C. C. A. 10th).

In the instant case the Tax Court's findings fail to disclose a real business purpose in the arrangement effected in the taxable year, and it is clear from the Tax Court's opinion (R. 38–40) that it was unable to find that a bona fide partnership had been created for federal income tax purposes. The record fully supports its conclusion and the court below affirmed it without comment. (R. 54.) It was unnecessary to consider the wife's status as a partner because of the community character of the earnings of the

business. But here, as in the *Tower* and *Lusthaus* cases, *supra,* and cases cited above, every ingredient productive of the business income in question—capital, services, control and management—emanated from the taxpayer or the marital community. The case is indistinguishable from *Belcher* v. *Commissioner, supra, Eisenberg* v. *Commissioner, supra, Hash* v. *Commissioner, supra, Dawson* v. *Commissioner, supra,* and *Benson* v. *Commissioner, supra.*

The decision below is not in conflict with any of the decisions relied upon by the taxpayer. (Pet. 8–9; Br. 17–23.) None of them except *Thomas* v. *Feldman,* 158 F. 2d 488 (C. C. A. 5th), involved the taxation of a partnership. The *Feldman* case is not in point because in that case the trial court had found as a fact that a bona fide partnership had been created and the Circuit Court of Appeals merely affirmed its decision because the finding was supported by the evidence. The other cases, except *Oyama* v. *California,* 332 U. S. 633, are cited by the taxpayer as authority for the argument that his purpose to avoid the effect of possible government freezing orders was a valid business purpose, and the latter is cited for the proposition that the bona fides of the so-called partnership cannot be questioned under the circumstances of this case. The cases are inapplicable, and the arguments are without merit here.

CONCLUSION

The decision of the court below is correct. It is fully supported by the facts and the law, and is not in conflict with any other decision. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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